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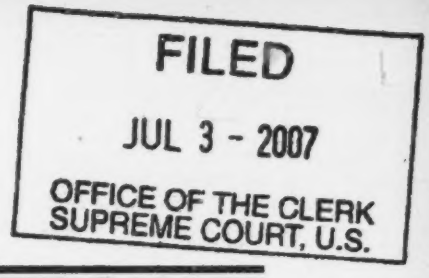

(6)

No. 06-1438

IN THE

Supreme Court of the United States

PAUL HUDSON, ET AL.,

Petitioners,

v.

AEP TEXAS NORTH COMPANY, ET AL.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

BRIEF OF TEXAS INDUSTRIAL ENERGY CONSUMERS AS RESPONDENT IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

This Petition raises an issue left open in *Entergy Louisiana, Inc. v. Louisiana Pub. Serv. Comm'n*, 539 U.S. 39 (2003). That is, in setting retail rates, do the States have authority to find that a utility's rate proposal is inconsistent with a Federal Energy Regulatory Commission (FERC) tariff that must be implemented in the retail rate proceeding?

PARTIES TO THE PROCEEDINGS

Petitioners are Paul Hudson, Chairman of the Public Utility Commission of Texas, and Julie Parsley and Barry Smitherman, in their official capacities as commissioners of the Public Utility Commission of Texas. Respondents are AEP Texas North Company; the Cities of Abilene, Ballinger, Cisco, San Angelo, and Vernon, Texas; and Texas Industrial Energy Consumers.

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BRIEF OF TEXAS INDUSTRIAL ENERGY CONSUMERS IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

Texas Industrial Energy Consumers (TIEC) files this brief in support of the Petition for Writ of Certiorari (Petition) of the Public Utility Commission of Texas (PUC).

TIEC is an association of large industrial users of electricity whose businesses are heavily impacted by electricity costs. TIEC's members purchase substantial amounts of electricity from AEP Texas North Company (TNC) and other American Electric Power (AEP) affiliates.[1] TIEC participated in the underlying proceeding at the PUC and in TNC's appeal of the PUC Order.

STATEMENT

TIEC incorporates by reference the statement of the case as set forth in the Petition.

SUMMARY OF ARGUMENT

The filed rate doctrine requires that the States implement Federal Energy Regulatory Commission (FERC) tariffs that set wholesale electricity rates. The Fifth Circuit's decision would require state utility commissions to accept and implement utility rate proposals that are inconsistent with FERC tariffs. The Fifth Circuit's ruling converts the filed rate doctrine's mandate that state commissions *must* give

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[1] TIEC's members in the AEP service area include Air Liquide Large Industries U.S. L.P., Celanese, Ltd., Chevron Global Power Corporation, CITGO Petroleum Corporation, Dow Chemical Company, E.I. du Pont de Nemours & Company, Flint Hills Resources, Invista S.a.r.l., Lyondell Chemical Company, Occidental Chemical Corporation, Occidental Permian, Ltd., and Valero Energy Corporation.

effect to FERC-approved tariffs into a doctrine that state commissions *cannot* give effect to FERC-approved tariffs if the state-regulated utility proposes to ignore the terms of the FERC tariff.

FERC has plenary jurisdiction to set wholesale rates. 16 U.S.C. § 824(b)(1) (2000 & Supp. 2006); *New York v. Fed. Energy Regulatory Comm'n*, 535 U.S. 1, 16-17 (2000). Setting retail rates, however, is within the States' police powers. *Arkansas Elec. Coop. Corp. v. Arkansas Pub. Serv. Comm'n*, 461 U.S. 376, 377 (1983). When setting rates in state regulatory proceedings, state commissions are routinely called upon to give effect to FERC wholesale rates under the filed rate doctrine, which is precisely what the PUC did in this case.

In a state proceeding to determine TNC's Texas jurisdictional fuel expenses and revenues, the PUC was called upon to give effect to a merger agreement among utilities, called the System Integration Agreement (SIA). *See* 16 TEX. ADMIN. CODE § 25.236(g) (2007). The SIA, approved as a FERC tariff, included a mechanism to calculate and allocate to Texas customers TNC's profits associated with sales of excess power. Because Texas retail customers pay through their regulated rates for the generation assets that produce TNC's power, those customers are allocated profits from the sale of a utility's excess power (called "off-system sales" or, under the SIA, "Trading Market Realizations" (TMR)). TEX. UTIL. CODE ANN. §§ 36.051; 36.203(e) (Vernon 1998 & Supp. 2006); 16 TEX. ADMIN. CODE § 25.236(d)(1) (2007).

The SIA came into effect upon the merger of American Electric Power Company (AEP) and Central and Southwest Corp. (CSW). The SIA included a method for allocating TMRs, which it defined as the difference between "revenues collected" and out of pocket costs. In the retail rate proceeding at issue, TNC included as pre-merger TMRs

revenues from certain open transactions of its sister utilities that *had not been collected.* The result of over-stating these pre-merger revenues was that TNC would be allocated a relatively smaller percentage of the post-merger TMRs. Artificially inflating the pre-merger revenues reduced the amount that TNC would have to credit to its Texas retail ratepayers, and AEP benefited because its other subsidiaries did not have to credit retail ratepayers for off-system sales in the same manner as TNC.

The PUC determined that TNC's proposal was inconsistent with the FERC tariff—a tariff the PUC was required to implement under the filed rate doctrine. The PUC refused to give effect to the utility's flawed application of its filed rate and set the utility's retail rates in accordance with the actual terms of the FERC tariff.

The Fifth Circuit erroneously relied upon prior Court precedent, *Entergy Louisiana, Inc. v. Louisiana Public Service Commission*, 539 U.S. 39 (2003), to determine that the States are preempted from disputing a utility's construction of its wholesale rate when that construction is inconsistent with the FERC tariff. *AEP Texas N. Co. v. Texas Indus. Energy Consumers*, 474 F.3d 581, 586 (5th Cir. 2006) ("If a state disputes a utility's interpretation of a tariff, FERC is the proper forum for resolving the disagreement."). The Fifth Circuit's holding is erroneous because *Entergy* did not hold that a state regulatory agency has no authority to construe a tariff and apply its terms in state proceedings. *Entergy*, 539 U.S. at 51.

Furthermore, unlike *Entergy*, where the utility operated under an interstate system agreement that gave it discretion to determine a methodology for allocating payments among affiliates, the SIA gave no such discretion to AEP Service Corporation (AEPSC), the service agent designated by the SIA to keep track of TMRs. Here, the system agreement unequivocally provided that TMRs only included those

revenues actually collected by the utility. Nowhere in the agreement did FERC give AEPSC discretion to interpret the portion of the tariff that is at issue in this proceeding.

The Fifth Circuit's holding creates havoc for state regulatory bodies. The holding bars the States from giving effect to a filed rate. Yet that is precisely what the States are required to do. *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 962 (1986) ("interstate power rate filed with FERC or fixed by FERC must be given binding effect by state utility commissions determining intrastate rates"). The holding also upsets longstanding practice at state utility commissions. State utility commissions are routinely called upon to implement and give effect to FERC tariffs in retail rate proceedings, and the Fifth Circuit decision would effectively prevent them from examining a FERC tariff and performing that task.

Taken to its logical end, the result of the holding is that Texas must blindly accept a utility's interpretation of its filed rate, no matter how preposterous, incongruous or blatantly wrong the interpretation. If the utility claims that the FERC tariff says X, when it is indisputable that the tariff says Y, the PUC must accept the utility's interpretation, implement the erroneous rate and then seek a remedy at FERC. *See* TEX. UTIL. CODE ANN. §§ 36.102(a), 36.108(c) (Vernon 1998 & Supp. 2006) (requiring the PUC to make a final determination regarding a utility's requested rate change within 185 days or the requested retail rate change goes into effect). State retail rate proceedings involving FERC-approved multi-state agreements are common, and the Fifth Circuit's holding makes little practical sense. The opinion hamstrings Texas' ability to timely set retail rates and invites electricity market manipulation by utilities.

This Petition provides the Court the opportunity to clarify an issue left open in *Entergy*. Specifically, the Court should clarify whether a state is preempted from giving effect

to the terms of a FERC tariff when a utility asks the state to ignore those terms.

REASONS FOR GRANTING THE WRIT

I. The Court Has The Opportunity To Squarely Address Whether The States Have Authority To Reject A Utility's Request To Disregard The Terms Of FERC Wholesale Rates In A Retail Rate Proceeding

A. The PUC Order Gave Effect To FERC's Authority Over Interstate Wholesale Rates By Applying The Filed Rate

The precedent related to FERC's plenary jurisdiction to set interstate wholesale rates is well established. FERC's jurisdiction to set interstate wholesale rates is exclusive. 16 U.S.C. § 824(b) (2000 & Supp. 2007). This Court has ruled that "FERC-mandated allocations of power are binding on the States, and States must treat those allocations as fair and reasonable when determining retail rates." *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 487 U.S. 354, 371 (1988).

Similarly, the Court has held that "[o]nce FERC sets such a rate, a state may not conclude in setting retail rates that the FERC-approved wholesale rates are unreasonable." *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 966 (1986). "[U]nder the filed rate doctrine, FERC-approved cost allocations between affiliated energy companies may not be subjected to reevaluation in state ratemaking proceedings." *Entergy Louisiana, Inc. v. Louisiana Pub. Serv. Comm'n*, 539 U.S. 39, 41-42 (2003). In short, the States are required to give effect to filed rates.

The PUC's Order reflects this mandate. The PUC reviewed the terms of the FERC tariff and applied its terms.

The PUC did not challenge the rate or attempt to alter any allocation. Rather, the PUC examined the utility's calculation of revenues from its off-system sales and, as required by the SIA, refused to include certain "base year" revenues that had not actually been collected.[2] The PUC logically and reasonably determined that the definition of TMRs stated in the tariff was not reconcilable with AEPSC's method of using "mark to market accounting" to calculate base year revenues from off-system sales.

The PUC's Order gave effect to the FERC tariff because the SIA itself explicitly defined TMRs as "the difference between i) the *revenues collected* from Trading and Marketing Activities and ii) Out-of-Pocket Cost of such Trading and Marketing Activities and any transmission cost related to such activities." (emphasis added) "Mark-to-market" accounting, on the other hand, is an accounting method by which assets are recorded at their current market value, which may be higher or lower than their actual purchase price or book value. The accounting method looks at the market price rather than the revenues actually collected by the utility for the trading activities.

The effect of using this accounting scheme was that AEP East's base year margins were inflated by including open

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[2] The SIA formula provided that TMR margins were to be allocated between AEP East and AEP West up to the level of realizations achieved in a "base year" (the pre-merger period of July 1999 through June 2000). AEP East's and AEP West's relative percentage of total TMRs from off-system sales established a "base year allocation." Any TMRs in excess of the level of realizations achieved in the base year were to be shared according to the ratio of owned generating capacity in the two zones. TNC and other former CSW companies that merged with AEP were in AEP West.

transactions that had not actually closed during the base year. This is significant because the tariff required TMRs to be allocated, in part, based on off-system sales margins during the base year. The parties in the reconciliation proceeding stipulated that the accounting scheme resulted in $7.9 million less in revenues for TNC than would have resulted if the base year revenues were calculated using only revenues actually collected. *AEP Texas N. Co. v. Texas Indus. Energy Consumers*, 474 F.3d 581, 583 (5th Cir. 2006). The PUC then applied the terms of the SIA and duly determined that the utility's retail rates should be reduced to reflect the $7.9 million.

B. The Fifth Circuit Erroneously Ruled That The PUC's Order Was Preempted

The Fifth Circuit erroneously ruled that the PUC was preempted from determining that the utility's application as filed was inconsistent with the FERC tariff at issue. *AEP Texas*, 473 F.3d at 586. Relying primarily on *Entergy*, the Fifth Circuit held that because the SIA authorized AEPSC to implement the formula for calculating TMRs, it granted AEPSC discretion to interpret what "revenues collected" during the pre-merger period meant. *AEP Texas*, 473 F.3d at 585.

This is faulty logic. Nowhere in the agreement was AEPSC granted authority to do anything other than input data to comply with the formula. And nowhere in the SIA was AEPSC authorized to calculate the base year allocation, the portion of the tariff at issue in this case. Indeed it would be odd for the agreement to have granted AEPSC such discretion since the base year allocation is based on transactions that occurred prior to the AEP-CSW merger and prior to the effective date of the SIA.

The Fifth Circuit overstepped the ruling in *Entergy*. In *Entergy*, the Court rejected the Louisiana Public Service

Commission's (LPSC) argument that, because FERC had not determined how certain generating units would be classified for purposes of making capacity payments among affiliates, LPSC had authority to second-guess the utility's methodology. *Entergy*, 539 U.S. at 50. The Court disagreed. The Court stated that "[i]t matters not whether FERC has spoken on the precise classification of ERS units, but only whether the FERC tariff dictates how and by whom that classification should be made." *Id.*

This ruling cannot stand for the proposition that a service agent that has been named to keep track of revenues has carte blanche to ignore *how* the tariff says they are to be calculated. Multi-state system agreements typically have a utility affiliate that acts as a service agent. This arrangement makes sense because implementation of the tariff requires access to the utility's books and access to confidential and proprietary business information. But the service agent must still implement the terms of a tariff. *Entergy* cannot mean that the naming of a service agent to apply a formula is tantamount to giving that agent discretion to compel a state commission to disregard *Nantahala's* directive to give effect to FERC-approved tariffs.

Furthermore, the facts of *Entergy* are distinguishable from the situation at bar. In *Entergy*, the Court addressed a state commission's authority to challenge the reasonableness of a utility's cost allocation under a system agreement where the FERC tariff granted the utility discretion to interpret the agreement. The Court held that "a FERC tariff that delegates discretion to the regulated entity to determine the precise cost allocation similarly pre-empts an order that adjudges those costs imprudent." *Entergy*, 539 U.S. at 42. In *Entergy*, the utility was given discretion to determine whether certain units were considered available capacity when calculating affiliate expenses for capacity. Here, AEPSC was not granted similar discretion. The terms of the SIA were

explicit that the base year allocation was to be based on revenues that had been collected—not hypothetical forecasts of revenues.

Because TNC proposed to calculate base year revenues in a manner that disregarded the FERC tariff, the need to clarify the holding in *Entergy* arises. In *Entergy*, the Court left open "the question of the exclusivity of FERC's jurisdiction to determine whether and when a filed rate has been violated." *Entergy*, 539 U.S. at 51. In the instant case, the Fifth Circuit has held that "pursuant to the filed rate doctrine, federal law preempts state regulators from making a final determination as to whether a FERC tariff has been violated and from imposing a remedy for the alleged violation." *AEP Texas*, 473 F.3d at 582. What the Fifth Circuit has done is to strip the States of authority to give effect to a federal tariff. This cannot be the intent of *Entergy*.

II. The Fifth Circuit's Holding Prohibits State Commissions From Giving Effect To Filed Rates In Retail Rate Proceedings

State commissions are routinely called upon to apply FERC tariffs in state ratemaking proceedings. Implementation of FERC wholesale rates in a state fuel reconciliation proceeding is one example. Texas law requires a regulated utility to periodically reconcile its fuel costs and revenues. 16 TEX. ADMIN. CODE § 25.236 (2007). If a utility under-recovers its fuel costs and expenses, ratepayers must pay back the utility in fuel surcharges. Likewise, if a utility over-recovers its fuel costs and expenses, the utility must issue refunds to its ratepayers. Determination of wholesale power costs and margins is necessary to determine a utility's fuel costs. Implementing FERC tariffs is also necessary in state proceedings to set

retail base rates.[3] *See* TEX. UTIL. CODE ANN. § 36.001 (Vernon 1998 & Supp. 2006).

The States have a duty to honor FERC tariffs under well-established precedent. *Natanhala*, 476 U.S. at 966 (requiring that States must "give effect" to interstate wholesale rates); *Montana-Dakota Utils. Co. v. Nw. Pub. Serv. Co.*, 341 U.S. 246 (1951) ("No tribunal may enter an order that would have the effect of "authoriz[ing] commerce in the commodity on other terms."). It cannot be the case that federal preemption with respect to interstate wholesale rates absolves the States of the duty to honor filed rates. But that is the effect of the Fifth Circuit holding. The lower court held that "[i]f a state disputes a utility's interpretation of a tariff, FERC is the proper forum for resolving the disagreements." *AEP Texas*, 473 F.3d at 586 (citing *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 487 U.S. 354, 375 (1988) (MP&L)). In the meantime, the States, which must timely act on retail rate change proceedings, must disregard the express terms of the tariff, in violation of *Natanhala*.

The Fifth Circuit's blanket ruling goes too far, and its reliance on *MP&L* is misplaced. In *MP&L*, the Court addressed whether the States could inquire into the prudence of a purchase where the reasonableness of the rates and agreement related to the purchase had been approved by FERC. The Court held: "The reasonableness of rates and agreements by FERC may not be collaterally attacked in state or federal courts. The only appropriate forum for such a challenge is before the Commission or a court reviewing the Commission's order." *MP&L*, 487 U.S. at 375.

The Petition does not present a reasonableness challenge to a FERC-approved tariff. Indeed, the Petition does not

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[3] "Base rates" generally cover all of a utility's costs other than fuel.

present a challenge to a FERC tariff at all. What the Petition presents is an opportunity for the Court to clarify whether the States have authority to implement the terms of FERC tariffs in retail rate proceedings, even where the utility has asked the state to disregard the terms of the FERC tariff. If the States do not have this authority, then the logical result is that a utility whose retail rates recover costs set in a FERC wholesale rate (as is typically the case) can require a state commission to implement a retail rate increase that violates the terms of its wholesale rate.

Examining what happens if this were to occur illustrates the consequences of the Fifth Circuit's ruling. The PUC is required by Texas law to make a final determination regarding a utility's requested base rate change within 185 days *or the requested retail rate change goes into effect.* TEX. UTIL. CODE ANN. §§ 36.102(a), 36.108(c) (Vernon 1998 & Supp. 2006). Assume that a FERC tariff provides that Texas ratepayers must pay $10 per kilowatt for wholesale power. Assume that the utility (which has the responsibility of calculating and keeping track of its power purchases) claims that Texas ratepayers should pay $10,000 per kilowatt. After discovery and cross-examination at a contested hearing, the parties to the retail rate proceeding discover the error. The utility refuses to acknowledge the error, and tells the PUC that, if it does not like its application, it can complain to FERC after it issues a final order.

The Fifth Circuit's ruling gives the States an unworkable remedy to a proposed violation of a filed rate. The PUC cannot apply a rate that runs afoul of the FERC tariff. Yet the PUC must rule on the application that proposed the violation of the filed rate within 185 days or the proposed rates go into effect. The Fifth Circuit's holding would require the PUC to allow the erroneous rate to go into effect, and then seek a remedy at FERC under the Federal Power Act. 16 U.S.C. § 825e (2000 & Supp. 2007). This places an

unreasonable burden and procedural hardship on the States, as well as regulated ratepayers who would be forced to pay higher rates based on the utility's misapplication of its filed rate.

If the States were to misapply the terms of a FERC tariff, a utility is not without a remedy. FERC is the ultimate arbiter of its wholesale tariffs. The utility has several options if it disagrees with the application of a tariff. The utility may seek a declaratory order from FERC regarding the meaning of the tariff. *California v. Fed. Energy Regulatory Comm'n*, 495 U.S. 490, 495 (1990); 18 C.F.R. § 385.207 (2007). If FERC decides in the utility's favor, FERC has authority under the Federal Power Act to bring an action in the proper District Court to enjoin the States' action. 16 U.S.C. § 825m (2000 & Supp. 2007). The utility may also, as it did here, seek to enjoin the Commission's order in a United States District Court of competent jurisdiction in order to prevent the PUC's application of its rate from going into effect.

Placing the burden on the States to enforce the terms of FERC tariffs, but giving them no authority to reject a utility's proposal that is inconsistent with those terms, makes little sense. The Fifth Circuit's ruling that the States must knowingly ignore the terms of a FERC tariff in a retail rate proceeding whenever a utility asks them to should be reversed.

CONCLUSION

The PUC's Petition For Writ Of Certiorari should be granted. The Court may wish to consider summary reversal.

Respectfully submitted,

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